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In the Supreme Court of the United States

OCTOBER TERM, 1924

UNITED STATES OF AMERICA AND FRANK K. Bowers, Collector of Internal Revenue, petitioners *v.* HENRY H. KAUFMAN, TRUSTEE IN BANKruptcy of Abraham Finkelstein, Israel Finkelstein, and Nettie Finkelstein, Individually, and as Copartners Trading as Finkelstein Brothers	No. 515

UNITED STATES OF AMERICA AND FRANK K. Bowers, Collector of Internal Revenue, petitioners *v.* ALFRED C. COXE, JR., RECEIVER OF JONES and Baker, Alleged Bankrupts	No. 516

ON CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES

STATEMENT OF THE CASE

Respondent in the first of the above-entitled cases is trustee in bankruptcy of Abraham Finkelstein, individually, and of Finkelstein Brothers, a

partnership, composed of Abraham Finkelstein and two others. Said partnership was engaged in business in New York City as manufacturers and importers of embroidery and dealers in cotton goods. An individual income tax return for the year 1919 was filed by Abraham Finkelstein under Sections 218 (a) and 223 of the Revenue Act of 1918. The entire income shown therein was derived from the partnership business and represented salary and the undistributed share of the partnerhip net income for 1919, previously reported under Section 224 of said act. The return was filed March 15, 1920, and at the same time $3,841.10, which was one-quarter of the total tax liability of $15,364.40, was paid. Subsequently the partnership and the partners, individually, went into bankruptcy. The balance of the tax, amounting to $11,523.30, plus statutory interest, has not been paid, and constitutes the basis of the Government's claim in this case.

Upon examination it was found that Abraham Finkelstein had no separate individual estate. *It is admitted that the total income of Abraham Finkelstein upon which the tax in question is based was derived from the partnership business* and the correctness of the tax is not questioned. The partnership assets are much in excess of the tax liability, but are not sufficient to pay all the partnership creditors in full.

In the second case Jones & Baker was a New York stock brokerage firm, now defunct, in which

William R. Jones and Jackson B. Sells were the sole partners. On May 31, 1923, the firm, an alleged bankrupt, was placed in the hands of respondent as receiver. In July, 1923, income taxes for 1918, 1919, and 1920 were assessed against Jones and Sells in amounts which on November 26, 1923, were reduced by stipulation to $273,-739.07 on the part of Jones and $5,518.41 on the part of Sells. On November 23, four months after the assessment and three days prior to the date of said stipulation, an offer of composition in bankruptcy was made by the firm to partnership creditors, as distinguished from the creditors of the individual partners. The tax claims are still outstanding. It is admitted that the taxes are correct. There are no separate individual estates, and partnership assets are not sufficient to pay all the partnership creditors in full. The same situation is presented in this case as in the Finkelstein case.

Claims for the taxes hereinbefore mentioned were filed against the respective partnership estates by Frank K. Bowers, Collector of Internal Revenue, on behalf of the United States. It was contended by the Government that said claims were payable out of the partnership assets prior to the payment of the general partnership creditors, whereas the trustee and receiver contended that the claims were only payable out of separate individual estates. Of such there were admittedly none, because the individuals had put it out of

their power to pay taxes by placing or leaving all their assets in the partnerships. The District Court for the Southern District of New York disallowed the claims in both cases based upon the referee's ruling in the Finkelstein case, and upon petitions for appeal the Circuit Court of Appeals in a single opinion affirmed the decrees. The cases come here on certiorari to the Circuit Court of Appeals.

The following are the statutes which are involved in these cases:

> Section 218(a) of the Revenue Act of 1918 (40 Stat. 1057, Chap. 18), which provides:
>
> "That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed."
>
> Section 224 of the same Act, which provides:

"That every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners."

Section 3466 of the Revised Statutes of the United States, which provides:

"Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority hereby established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed."

The Bankruptcy Act of July 1, 1898 (30 Stat. 544, Chap. 541, as amended), containing in Section 5 the following subdivisions:

"(f) The net proceeds of the partnership property shall be appropriated to the payment of the partnership debts, and the net proceeds of the individual estate of each

partner to the payment of his individual debts. Should any surplus remain of the property of any partner after paying his individual debts, such surplus shall be added to the partnership assets and be applied to the payment of the partnership debts. Should any surplus of the partnership property remain after paying the partnership debts, such surplus shall be added to the assets of the individual partners in the proportion of their respective interests in the partnership.

"(g) The court may permit the proof of the claim of the partnership estate against the individual estates, and vice versa, and may marshall the assets of the partnership estate and individual estates so as to prevent preferences and secure the equitable distribution of the property of the several estates."

Section 64 (a) of the Bankruptcy Act, which provides:

" The court shall order the trustee to pay all taxes legally due and owing by the bankrupt to the United States, State, county, district, or municipality in advance of the payment of dividends to creditors, and upon filing the receipts of the proper public officers for such payment he shall be credited with the amount thereof, and in case any question arises as to the amount or legality of any such tax the same shall be heard and determined by the court."

The single question presented may be stated as follows:

Is the United States entitled to be paid out of partnership assets in bankruptcy ahead of general creditors for taxes assessed against the partners based on their distributive shares of partnership income which they have not withdrawn, and where they have placed or left all their personal assets in the partnership so that they have no individual estates out of which to pay the taxes assessed against them?

ARGUMENT

It is the contention of the United States in these cases that the question presented, as it is above stated, should be answered in the affirmative; that, to be specific, and referring to the Finkelstein case for illustration, as we shall throughout this argument, the United States is entitled to be paid out of the assets of Finkelstein Brothers and ahead of partnership creditors the $11,523.30 still due from Abraham Finkelstein as a tax upon income derived solely from the partnership and by him left in the partnership and constituting a part of its assets.

Obviously the contention which we thus make must fail unless we can reconcile it with subdivision (f) of Section 5 of the Bankruptcy Act of July 1, 1898, set out in full above, requiring in substance that the proceeds of partnership property shall be appropriated to the payment of partnership debts ahead of the debts of the individual partners. It

is upon that provision that respondents rely and that the court below based its decision.

I

The provision referred to does not defeat the claim of the United States for the reason that *the United States has a lien or priority in the nature thereof as to the taxes due it giving it precedence over general partnership creditors.*

Such was the precise holding of Runyon, District Judge, in the *Matter of Brezin & Schaefer* (297 Fed. 300 (D. C. N. J.), decided January 25, 1924), in which similar facts and the same question were involved. There Walter Brezin and Hugo Schaefer were partners trading as Brezin & Schaefer. They were adjudicated bankrupt both individually and as partners. The United States filed a priority claim for taxes against the partnership estate for taxes assessed against the partners individually, but based on partnership income. It was objected that the claims were invalid against the partnership estate, and that there were no assets in the individual estates. The testimony showed that the partners left a considerable portion of the net profits of the partnership business undistributed. The court held that the United States could collect. It said in part (p. 304 et seq.):

> There is no dispute but that, on these various days, there were actual funds in being, voluntarily left by Brezin and

Schaefer among the partnership moneys, and which, if they had been claimed by the partners as individuals—as with perfect propriety they could have been claimed under the articles of copartnership—would have more than sufficed to put the individuals in possession of resources out of which these taxes could have been paid and satisfied. Has the refusal or neglect of the partners to claim their individual rights from time to time, their election to leave their respective personal moneys in their business enterprise, so changed the character of those moneys, so undermined the government's claim, as practically to nullify it, and, at the same time, put in possession of the Trustee, for the benefit of partnership creditors, many thousands of dollars which, as the result of the partners' mere election, are listed as partnership funds; whereas, they were actually, at all times throughout the period herein involved, individual funds even though unclaimed? I believe not. * * *

It should be borne in mind that this proceeding is not designed to tax the partnership for taxes due from the individuals, and therefore runs in no wise counter to the Revenue Acts of 1917 and of 1918. The taxes herein have been assessed against the individuals, and all that is now sought is an available and proper fund out of which to collect the same as so assessed.

The government's claim for taxes is not to be classed with a creditor's claim for the

> payment of an ordinary debt, for "taxes are not debts, but imposts levied for the support of the government." * * *
>
> Therefore, in my opinion, the Government's claim, being in the nature of an equitable lien, has followed the property into the hands of the Trustee in Bankruptcy, where it awaits satisfaction. * * *
>
> Inasmuch as the undistributed profits in a partnership are to be used, so far as they extend, as the basis for the computation of an individual income tax, a partner possessed of such profits certainly has a taxable income; and such income, even in the guise of partnership funds, is available for collection as well as computation purposes.

The entire opinion of Judge Runyon in the *Matter of Brezin & Schaefer* is set out in the appendix to this brief.

The right to priority of payment here claimed and recognized under like circumstances in the *Matter of Brezin & Schaefer* arises from the following provisions of the statutes read in connection and considered together with that section (subdivision (f) of Section 5 of the Bankruptcy Act of July 1, 1898) whereon respondents rely:

First. That part of Section 218 (a) of the Revenue Act of 1918 (40 Stat. 1057, Chap. 18) which provides that the individual partner shall be liable for income tax computed on his distributive share of the net income of the partnership, *whether distributed or not.*

Second. Section 3186 of the Revised Statutes of the United States (37 Stat. 1016), as amended, which provides that—

> If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount shall be a lien in favor of the United States from the time when the assessment list was received by the collector, except when otherwise provided, until paid, with the interest, penalties, and costs that may accrue in addition thereto, upon all property and rights to property belonging to such person; * * *

Third. That part of Section 3466 which gives priority in case of insolvency to the debts of the United States.

Fourth. That part of Section 64 (a) of the Bankruptcy Act which provides that out of the estate of a bankrupt taxes due the United States and other governmental units shall be paid in advance of the claims of creditors.

The right to priority in payment out of the assets of the partnership, under the circumstances of these cases, whether it be called a legal lien, an equitable charge, or a right of priority in the nature of an equitable lien, we submit is clearly contemplated by these various provisions of the statutes. Certainly, Congress did not intend that a partner by his own acts should place rights to property or income beyond the reach of the taxing authorities and thereby deprive the government of tax in violation of the plain intent of all the law.

Adjudication in bankruptcy in the Finkelstein case took place April 1, 1921, long before which date the government had obtained a legal lien on Abraham Finkelstein's property and rights to property to secure the payment of the income tax assessed against him by reason of income derived solely from the partnership and left by him in the partnership. For the purpose of assessment that income, although undistributed, although at all times a part of the assets of the partnership, was treated by the law as the property of the partner, as his gain, his income. If his property for that purpose, that is to say, for the purpose of assessment, certainly it should also be regarded as his property within the meaning of the statute creating a lien in favor of the government upon all property or rights to property belonging to the tax debtor, and that notwithstanding the general doctrine of the law of partnership that the partner's only right to property in the assets of the partnership is his equity to share in the partnership estate after the payment of partnership creditors.

The lien for taxes having attached before bankruptcy and Abraham Finkelstein having placed and left all his property in the partnership, the lien ran to this property for an amount far in excess of the tax liability. The tax liability was \$11,523.30. Abraham Finkelstein's distributive share of the partnership income for 1919, left by him in the partnership, was \$59,440.99. The part-

nership creditors had only general unsecured claims. With its lien, therfore, the government has a legal right to prior payment ahead of the partnership creditors.

But aside from its legal lien and the legal rights derived therefrom, the government has a claim which constitutes an equitable charge upon the partnership estate superior to any rights of the partnership creditors. The partnership estate was unduly and therefore unjustly enriched by enhancement from the property of the individual partner, and in fairness and equity must account for the increase.

The United States has a valid claim against the partnership estate for taxes due and owing to it by reason of the merger of Abraham Finkelstein's property with the partnership assets, and its right of priority in payment thereof (here to satisfaction by the partnership estate of the legal and equitable charge upon it) applies equally whether the debt be of an equitable or legal nature. (*U. S.* v. *Barnes*, 31 Fed., 705; *Howe* v. *Sheppard*, 12 Fed. Cas. No. 6,772.)

It goes without saying that the trustee in bankruptcy takes the assets of the bankrupt estate subject to all *bona fide* liens, legal and equitable against it. (Section 67 of the Bankruptcy Act.) For this purpose he stands in the shoes of the bankrupt. The lien provisions of the Federal Statutes (Sec. 3186, U. S. R. S.) are not affected by the Bankruptcy Act (Sec. 67), and the prior-

ity provisions (Secs. 3466 and 3467, U. S. R. S.) are in *pari materia* with the Bankruptcy Act (Trust Co. v. Surety Co., 224 U. S. 152), and give the United States a right to priority in payment which persists against a bankrupt estate, so that the person becoming possessed of the bankrupt's assets is made a trustee for the United States and is bound to pay its claim first out of the bankrupt's estate.

This priority must be satisfied out of any available fund, and the partnership estate constitutes such a fund in this case since it is charged with a lien for the payment of taxes due from Abraham Finkelstein, he having merged his own estate in the partnership estate. The United States has a legal and equitable claim against the entire partnership assets for the prior payment of its taxes, such claim arising from the partner's interest being left therein. The partnership estate was swelled abnormally by the undistributed income and other assets of Abraham Finkelstein which should have paid the tax in the year when it was due.

The United States, however, does not need an express lien on the assets existing at the time they passed into the trustee's hands in order to succeed in this case, for it had a priority right to payment from the time the taxes became due, and this right extended to the partnership assets by reason of the property which Abraham Finkelstein had placed

or left therein. In *Marshall* v. *New York,* 254 U. S. 380 at 386, Mr. Justice Brandeis said:

> The right of priority has been likened to an equitable lien. *State* v. *Rowse,* 49 Missouri, 586, 592. The analogous preference in payment to claims for labor by state statutes, and to which the Bankruptcy Act gives priority, have been described as being "tantamount" to a lien. *In re Laird,* 109 Fed. Rep. 550, 555; *In re Bennett,* 153 Fed. Rep., 673, 677. The priority is a lien in the broad sense of that term which includes "those preferred or privileged claims given by statute or by admiralty law."

And in *Ruling Case Law,* Vol. 26, Sec. 348, it is said that even where there is not an actual legal lien, yet the right of priority of payment of taxes constitutes in its own nature an *equitable lien* on the taxpayer's property, and that property in the course of administration under the Bankruptcy Act is not freed from liens or claims for taxes.

Section 3466 of the Revised Statutes gives the United States a right of priority in payment of its claims which is upon the authorities cited the equivalent to a lien. Since the tax in this case became due before bankruptcy, the "equitable lien" extended to Abraham Finkelstein's partnership property and could only be satisfied by payment. This would be true even though there were no legal lien or the still more important equitable charge which rests upon the partnership assets.

As stated in the Marshall case, the priority or lien extends to the debtor's property whether in his own possession or that of a third person or in *custodia legis*.

It follows, of course, that the existence either of a legal lien, equitable charge, or equitable lien in favor of the United States and attaching to the partnership assets removes the claim of the United States from any effect of subdivision (f) of Section 5 of the Bankruptcy Act, even if that provision of the law might otherwise preclude priority in favor of the United States.

II

The rights of the partnership creditors, being derivative through the partners, are postponed to the superior right and equity of the United States

Whatever equity the partnership creditors have under the doctrine as to marshalling assets is a derivative one, not held or enforceable in their own right. It is practically a subrogation to the equity of the individual partner, to be made effective only through him. Hence, if he is not in a position to enforce it, the creditors of the firm can not be. (*Case* v. *Beauregard,* 99 U. S. 119; *Rice* v. *Barnard et al.,* 20 Vt. 476; *Appeal of the York County Bank,* 32 Pa. St. 446.)

In the case of *Schmidlapp* v. *Currie,* 55 Miss. 597, the Court said that the doctrine as to marshalling assets was only a principle of administration adopted by the courts in winding up a business, and

that the principle "springs alone out of the obligation to do justice between the partners."

If the principle as to marshalling assets springs out of the obligation to do justice between the partners, it becomes pertinent to inquire what the obligation is here; whether there is any equity as between the partners that partnership creditors shall be paid before the outstanding tax; and whether any derivative equity arises in the creditors where undisturbed income on which the tax has not been paid has swelled the partnership assets. The government has a prior equity and this equity constitutes an equitable charge upon the partnership assets over and above its lien. The partnership assets are a fund for the liquidation of the outstanding tax liability, and the obligation between the partners is that the benefited estate shall pay the tax.

Creditors transact business subject to tax claims of all kinds, and with constructive knowledge thereof, and this is true whether the claims constitute an equitable or legal lien upon the assets to which the creditors look for payment of their debts. The trustee stands in the shoes of the bankrupt, merely taking the assets with such a status as to protect his possession which, however, is subject to all bona fide liens, legal or equitable. The creditors here are common creditors without liens or priority, and they have no right to the assets until prior legal and equitable claims and charges against these assets are paid. As the creditors of the partnership are general debt

creditors and have no preferred status, they can not stand on a parity with the United States.

The liens of the government, legal and equitable, would have been valid as against the creditors of the partnership before bankruptcy, and therefore they are valid as against the estate in the Trustee's hands. Such liens are in no way abrogated or adversely affected by the Bankruptcy Act. (Section 67 of the Bankruptcy Act of 1898, as amended.)

In *Titus* v. *Maxwell, Trustee of Hamden*, 281 Fed. 433 (6th C. C. A.), decided July 14, 1922, one partner sold his interest in the partnership to the other partner and took notes secured by a chattel mortgage on all the partnership assets. The latter went into bankruptcy shortly thereafter without the notes having been paid and his trustee filed a petition to discharge the proceeds of sale of the assets from the lien of the mortgage, basing his rights upon the proposition that, the partnership having been in debt when the chattel mortgage was given, its creditors must be paid in full before the partnership property or assets could be diverted into any other channel. On appeal the Circuit Court of Appeals reversed the District Court (which had denied the right of the assignee of the vendor partner to share in the assets until after the claims of the partnership creditors were paid in full) and said, after referring to the general equity rule respecting the

marshalling of assets and its application to bankruptcy by Section 5(f) of the Bankruptcy Act:

> "It was long since declared to be the rule in equity that the right of partnership creditors to appropriate the partnership property specifically to the payment of their debts is derived, not through specific lien, but by a sort of subrogation through the partner whose original right it was to have the partnership assets applied to the payment of partnership obligations; that this equity of the partnership creditors subsists so long, and so long only, as that of the partner through whom the equity is derived remains," and thereafter "the equities of the partners are extinguished, and consequently the derivative equities of the creditors are at an end."

The court was correct in finding in favor of the creditor of the individual bankrupt in preference to the creditors of the partnership because of such creditor's superior right or equity, notwithstanding it at the same time affirmed the general equity rule as to marshalling assets. In this connection it should be noted that the lien of the creditor of the individual bankrupt was allowed as to *all* the partnership assets.

The conclusion is irresistible that Abraham Finkelstein (who had placed all the property that he had in the world in the partnership, included in which was the very income on which the unpaid taxes in question were based and assessed, and with

respect to which the Government has both a lien and an equitable charge which it asserts are of an even higher nature than the lien of the preferred creditor in *Titus* v. *Maxwell*) had and has no right to have the partnership assets applied to the payment of claims of partnership creditors before satisfaction of the taxes due the United States.

As a legal and equitable lienor with a claim for taxes which has priority over the general claims of the partnership creditors, the United States is entitled to be paid first out of the assets of the partnership estate.

Bankruptcy does not affect such right of priority, since the United States is not named in, nor bound by, the section and rule (5f) as to the marshalling of assets; and even if it were, the equitable charge upon the partnership assets for the payment of the outstanding tax would entitle the Government to be paid first.

III

The right of the United States to priority in payment for taxes is not controlled by the general rule of partnership law as to marshalling assets

It is a well-established principle that in the application and interpretation of statutes the sovereign is not to be held bound by a law in which it is not specifically named. This rule is an extension of the English doctrine to the same effect, and has formed part of the American system of jurisprudence from its beginning. In the first

volume of *Kent's Commentaries on American Law* (3d Ed.), 460, it said:

> It is likewise a general rule, in the interpretation of statutes limiting rights and interests, not to construe them to embrace the sovereign power or government, unless the same be expressly named therein, or intimated by necessary implication.

In the case of *In re Strassburger et al.*, 23 Fed. Cas. No. 13,526 (4 Woods, 557), the Court said:

> The Bankruptcy law (Rev. St., Sec. 5121; 14 Stat. 534) prescribes a marshalling of assets between partnership and individual creditors. But it has been held in several cases that the bankrupt law is not binding on the United States. *U. S.* v. *Herron,* 20 Wall. (87 U. S.), 251; *U. S.* v. *The Rob Roy* (Case No. 16,179), *The earlier act of 1797* (Rev. St. Sec. 3466; 1 Stat. 515), gives to the United States priority over all other creditors in cases of the bankruptcy or insolvency of any person or persons indebted to it, and the bankrupt act recognizes this preference by making debts due to the United States the first in order to be paid out of the Bankrupt's estate, after paying the fees, costs, and expenses. Rev. St., Sec. 5101 (14 Stat. 530).

Although the Bankruptcy Act of 1867 was referred to in this case, yet the present act is in all respects the same on the point of marshalling assets, and the same rule applies. Neither Section 5(f) of the present Act nor Section 36 of the Act

of 1867 mention the United States as a creditor against whom assets may be marshalled so as to deprive it of any rights which it may have in the collection of its taxes, and they are not applicable to the Government under the circumstances of this case. Taxation is one of the high and indispensible attributes of sovereignty, and the Government's right of priority over other creditors is enlarged rather than limited by any provision of the bankruptcy laws. (See *Marshall* v. *People,* 254 U. S. 380.)

In the case of *Lewis* v. *United States,* 92 U. S. 618, counsel for the trustee of several bankrupt estates directly raised the question of the marshalling of assets, and the court specifically held that the United States was not bound by that rule, and further that the priority given the United States for the payment of its claims by the Bankrupt Law (to wit, that taxes and debts shall be paid first) and by the Statute of 1797 (Section 3466 of the Revised Statutes of the United States) to wit, that where there is a debt and bankruptcy, the United States shall have priority of payment, superseded the rule in equity recognized by the Bankruptcy Act, namely, that partnership property is to be first applied in payment of the partnership debts, and individual property in payment of the individual debts. It said that neither statute (Bankrupt Law or Act of 1797) contained any qualification, and that it could interpolate none.

In the decision of this case in the Circuit Court, 22 Int. Rev. Rec., 39, affirmed by the United States Supreme Court, the Court said:

> "How can a claim preferred by an Act of Congress absolutely, without exception or qualification, be postponed to the claims of other creditors by force of an equitable maxim never intended to be applicable to the case of a claimant who has a superior right by law?" "The right to priority of payment is a legal right, not a merely equitable one. It is called into existence by the bankruptcy of the debtors, but it is not created by the bankrupt law."

In the case of *In re Strassburger et al.*, 23 Fed. Cas., 13,526, the Court said:

> The government is not bound by the general equity rule for marshalling assets, nor by the rule prescribed by the bankrupt act in conformity thereto, any further than as that rule is founded in the particular case on the lien of the several parties *inter sese.*

The lien of the government for taxes is superior to the lien which partners might have under other circumstances to have the partnership funds used first for the payment of partnership debts. The United States has a preference given by law, and Abraham Finkelstein having placed all his property in the partnership estate, the partnership property is liable for the payment of the tax indebtedness, and the partnership creditors must be postponed and take subsequent to the rights of the United States.

In the *Strassburger* case two bankrupt partners (one as principal and the other as surety) were indebted to the United States for internal revenue taxes on distilled spirits, a judgment having been obtained against them and another surety between the time of the filing of the petition in bankruptcy and adjudication, and the Court held that neither partner had a lien on the partnership assets for the payment of partnership debts before the payment of their individual indebtedness to the government, and that the rights of the creditors being derivative were postponed. It was said that an execution against both partners would be leviable on the corpus of the partnership property, and *not merely on the interest of the partners after payment of the partnership debts*, and further that although equity in ordinary cases and under other circumstances might marshal assets according to the usual doctrine, *yet the United States was not subject to such equities.*

After holding as it did, the Court made the following very important observation:

> This view renders it unnecessary to examine the question of the admissibility of parol evidence to show that *the distilling on which the tax arose was really carried on by the partnership.* (Italics ours.)

Had there been occasion to consider this last point the Court would undoubtedly have reached the same result and found in favor of the United States regardless of any question of equities as between the partners.

The same is true in the Finkelstein case. *The income by which the tax was measured, and on which it was based and assessed, was that of the partnership obtained through the conduct of the partnership business, and was in no sense a tax on individual income of the partners secured through individual channels and apart from the partnership business.* (Transcript of Record, Stipulation, page 12.)

Furthermore,the law provides that the Court may marshall the assets of the partnership estate and individual estates *so as to secure the equitable distribution of the property of the several estates.* (Section 5g of the Bankruptcy Act.) This provision could have no effective meaning unless it were contemplated that situations might arise which would furnish exceptions to the general rule as to marshalling assets.

Moreover, Section 5(f) of the Bankruptcy Act concerning the marshalling of assets does not mention or refer to the United States or taxes in any way. It refers to *debts* owing *creditors,* not to *taxes* or the *United States. Taxes are not debts* but " imposts or demands levied for the support of the Government," *and are of a higher nature than debts* (*New Jersey* v. *Anderson,* 203 U. S. 483; *Meriwether* v. *Garrett,* 102 U. S. 472; *Lane County* v. *Oregon,* 7 Wall. 71; *United States* v. *Proctor,* 286 Fed. 272, decided in 1923), and the government's priority can not be affected except by express words

to that effect (*United States* v. *Herron*, 20 Wall. 251.)

Section 5(f) of the Bankruptcy Act limits rights and privileges. Therefore it is not binding on the Government, since it is well settled that the United States is not bound where not expressly named. (*Lindsey* v. *Miller*, 8 Pet. 666; *Gibson* v. *Chouteau*, 13 Wall. 99; *United States* v. *Dalles, etc., Co.*, 140 U. S. 632.)

IV

Conclusion

For the reasons hereinbefore set out we urge that in the Finkelstein case the United States is entitled to priority in payment out of the partnership assets. The same reasoning applies to the second case, No. 516, *United States et al.* v. *Coxe, Receiver of Jones and Baker, etc.* The two cases were submitted below upon the theory that the facts were the same. Substantially, the facts are identical and the cases were so treated below and are so treated herein, although it should be pointed out that in the second case it was not specifically proved or admitted that the individual income taxed was solely derived from the partnership business. (See stipulation at page 45 of the Record.)

Respectfully submitted.

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JANUARY, 1925.

APPENDIX

Opinion of the United States District Court for the District of New Jersey in the *Matter of Brezin & Schaefer* (297 Fed. 300), presenting the same question as that involved here.

OPINION

RUNYON, District Judge: The essential facts herein are as follows: Walter Brezin and Hugo Schaefer were partners trading as Brezin & Schaefer, and engaged in silk manufacture in Paterson, N. J., during the years 1917, 1918, 1919, and a portion of 1920.

In December, 1920, as the result of an involuntary petition filed against said partners, both as individuals and as partners, they were adjudicated bankrupts. On April 28, 1922, Frank C. Ferguson, collector of internal revenue for the Fifth District of New Jersey, filed a proof of claim with the referee in bankruptcy for taxes claimed to be due from the bankrupts to the United States. Thereafter, on May 31, 1922, he filed another claim for additional and further taxes, and on September 21, 1922, still another amended and corrected proof of claim for the sum total of the two prior claims. This claim, in short, was as follows: Against Brezin & Schaefer, additional taxes for the fiscal year ending June 30, 1917, and the ensuing period ending January 1, 1918, aggregating $1,232.01; against Walter Brezin, unpaid and additional taxes for the years 1917,

1918, and 1919, aggregating $6,865.62; and against Hugo Schaefer for like items and for the same period, aggregating $6,836.34.

In each of said claims preference and priority of payment was claimed under sections 3466 and 3467 of the United States Revised Statutes (Comp. St. §§ 6372, 6373) and section 64a of the Bankruptcy Act of 1898 (Comp. St. § 9648).

Within a month thereafter, the trustee for the bankrupts filed a petition setting forth his objections to the final proof of claim, as follows: (a) That the claim was not filed within one year, as limited by the Bankruptcy Act. (b) That no claim was filed by the United States in this court within one year from the date of adjudication. (c) That the claim does not set forth facts constituting any valid claim by the United States against the estate of the said bankrupts or the trustee thereof, or the assets of property belonging to the estate, either as individuals or as partners. (d and e) That neither partner individually nor the partnership did or does owe the United States taxes for the fiscal years ending June 30, 1917 and 1918, respectively. (f) That Walter Brezin did not and does not owe taxes to the United States for 1917, 1918, 1919, or any part thereof. (g) The same as next hereinabove as to Hugo Schaefer. (h and i) That no assets of any kind belonging to the individual partners came into possession of the trustee in bankruptcy.

The petitioner then prayed for an order disallowing and rejecting the claim of the United States and for further relief.

An order to show cause, issued by and returnable before the referee in bankruptcy next ensued,

and, as a result of the hearing had before him, the referee made an order reciting that the claim as against the partnership, amounting to $1,232.01, should be allowed; that all the assets which came into the trustee's possession were assets of the partnership, except $1,000 realized from the individual estate of Hugo Schaefer; that the partnership assets are not liable for the payment of taxes owed by the individual partners; and that neither of the individual partners had any taxable income for the years 1917, 1918, and 1919, which could form the basis for the imposition of a tax claim against them as individuals.

The referee then ordered that the claim of the United States in said sum of $1,232.01 be allowed with interest, that the said claim in all other respects be disallowed, and the trustee instructed that the same does not constitute a claim against the estate in his hands.

The United States thereupon filed its petition for review, claiming that the referee erred in two particulars, viz: (1) In finding that the partnership assets are not liable for the payment of taxes owed by the individual partners. (2) That neither of the individual partners had any taxable income for the years stated above which could form the basis of a tax claim against them; and praying that the order be reviewed and reversed, so far as it disallows the claim of the United States and instructs the trustee that said claim does not constitute a claim against the estate in his hands.

The taxes claimed from the partnership were the additional excess profits taxes for the fiscal year ending June 30, 1917, and the additional half year, ending January 1, 1918. These amounted to

$1,232.01, and, as neither party hereto has objected to that portion of the referee's order which provides for the payment thereof, we are in nowise concerned therewith.

(1) Although not certified to this court for review, the fact that the trustee largely emphasizes the point in his argument makes the first matter calling for consideration the question as to whether or not the United States is barred from pressing its claim, not having filed the same within one year from the date of adjudication. The trustee relies upon section 57n of the Bankruptcy Act, and upon the *Anderson Case* (C. C. A.) 279 Fed. 525, in support of his contention.

The language of section 57n (Comp. St. § 9641) is in part, as follows:

> Claims shall not be proved against a bankrupt estate subsequent to one year after the adjudication. * * *

While in the *Anderson Case* the court, among other things, said:

> The United States must file its claim for taxes as any other creditor, if it desires to share in the estate, and the court must determine any question arising as to the amount or legality of such tax.

The question of limiting the time of the United States for the filing of claims has been many times presented to the courts for decision and the general trend of opinion has been to the effect that the government is not bound as are ordinary creditors. *In re Price & Walter* (D. C.), 131 Fed. 546; *In re Fisher & Co.* (D. C.), 148 Fed. 907.

The *Anderson Case,* while seeming to hold to the contrary, really goes no further than to rule that the Government cannot, after notice, indefinitely refuse to present its claim. More than two years had elapsed after adjudication of bankruptcy in this case, and the trustee, desirous of settling the estate, prayed for—

> an order barring and foreclosing the United States from participating in the estate herein, or in the alternative that the United States be directed to file its claim or claims with the referee herein on or before a day certain, in order that the trustee may object thereto and hearings had on said claim in accordance with law.

The United States appeared specially and apparently was satisfied to move a dismissal of the trustee's petition on the ground that the court was without jurisdiction and that service upon the collector of internal revenue was not service upon the United States. These objections being overruled by the referee, testimony was taken on behalf of the trustee, and an order entered barring the United States from participating in the estate for any income tax for the year 1917. The District Court affirmed the referee's order and the Circuit Court of Appeals, after quoting section 64a of the Bankruptcy Act, and calling attention to the fact that it constitutes "a departure from the principles of public policy theretofore prevailing as to the rights of the sovereign which were recognized in the previous acts of 1800, 1841, and 1867," quotes in support of that conclusion, and as defining the scope thereof, the language of

the Circuit Court of Appeals in the case of *In re General Film Corp.*, 274 Fed. 903, as follows:

> We regard this section (64a) as binding on the government because it is named therein and, while conferring priority, as giving the bankruptcy court the power to hear and determine any question that arises as to the amount or legality of a tax assessed by it. The provision applies to taxes of all the persons mentioned, and we could not differentiate the government from the other persons in the absence of language justifying it.

The Anderson opinion then goes on to say:

> The United States must file its claim for taxes as any other creditor, if it desires to share in the estate, and the court must determine any question arising as to the amount or legality of such tax. It can not stand by, as it did here, after permission having been granted to file its claim, and expect to subsequently collect the tax from the bankrupt or his trustee. To permit such a procedure would make it impossible to say when there could be a winding up of the bankruptcy proceedings and a distribution of the assets.

The departure in public policy above noted consists in giving the federal courts jurisdiction as to the amount of legality of any tax, and apparently putting the United States on a par with other taxing divisions. Section 74a expressly recognizes priority and is silent as to any limitation of time, simply making it mandatory that the courts shall order the payment of taxes in advance of payments to creditors.

While it makes a distinct departure from the provisions of section 28, subd. 5, of the previous act (14 Stat. 531) which says " that nothing contained in this act shall interfere with the assessment and collection of taxes by the authority of the United States or any state," it encroaches in no wise upon the authority of section 57n of the Bankruptcy Act, which states that " claims shall not be proved against a bankrupt estate subsequent to one year after the adjudication, * * *" and as this section fails to name the United States in any way, it follows that there is applicable thereto the well-established principle that a sovereign can not be bound by a statute of limitations in which it is not named.

As to ~~the~~ exemption of the United States from the limitation of time, see *In re Stoever* (D. C.) 127 Fed. 394; *In re Cleanfast Hosiery Co.*, 4 Am. Bankr. Rep. 702 (Re. N. Y.); *In re Prince & Walter* (D. C.), 131 Fed. 546; *In re Fisher & Co.* (D. C.), 148 Fed. 907.

In the case of *United States* v. *Birmingham Trust & Savings Co.*, 258 Fed. 562, 169 C. C. A. 502, the Circuit Court of Appeals for the Fifth Circuit speaks as follows:

> The right of the United States to present a claim in a bankruptcy case at any time while the bankruptcy is pending and the funds thereof are not distributed can not be disputed.

Under the circumstances of the present case the above language seems entirely appropriate, and I am of the opinion that the United States is altogether within its rights in the presentation of

its claims despite the fact that more than one year had elapsed since the bankruptcy adjudication, especially as the funds in the trustee's hands to a considerable extent remain undistributed, and property in the course of administration under the Bankruptcy Act is not freed from liens or claims for taxes. 29 L. R. A. 280, 283; *In re Epstein,* 156 Fed. 42, 84 C. C. C. 208, 17 L. R. A. (N. S.) 465; *Stokes* v. *State,* 46 Ga. 412, 12 Am. Rep. 588.

(2) The referee certifies that all the assets which came into the trustee's hands were the assets of the partnership, except $1,000, which was realized from the individual estate of Hugo Schaefer.

The testimony shows that each of the partners was entitled to 50 per cent of the net profits of the partnership and a salary of $10,400 per year. The partners, instead of drawing out their respective 50 per cent shares of the net profits from year to year, left a considerable portion in the business undistributed, and during the years 1917, 1918, and 1919 the distributive share of each partner, in excess of the amounts actually withdrawn by him, totaled $26,140.05, or a little more than $52,000 in all, left in the business.

The Government tax, assessed against the two partners individually for the same three years, totaled $13,701.98; each partner being assessed for approximately one-half thereof, and the taxes so assessed not having been paid.

Pursuant to the conclusions already reached hereinabove, there would seem to me to be no doubt as to the government's right to priority of payment, provided only that there be funds in existence

properly chargeable with such payments. And in this connection it must be remembered that the taxes here sought are claimed as having accrued on the various dates when, under the income tax laws then in force, they originally became due and payable. There is no dispute but that, on these various days, there were actual funds in being, voluntarily left by Brezin and Schaefer among the partnership moneys, and which, if they had been claimed by the partners as individuals—as with perfect propriety they could have claimed under the articles of copartnership—would have more than sufficed to put the individuals in possession of resources out of which these taxes could have been paid and satisfied. Has the refusal or neglect of the partners to claim their individual rights from time to time, their election to leave their respective personal moneys in their business enterprise so changed the character of those moneys, so undermined the government's claim as practically to nullify it, and, at the same time, put in possession of the trustee, for the benefit of partnership creditors, many thousands of dollars which, as the result of the partners' mere election, are listed as partnership funds, whereas, they were actually, at all times throughout the period herein involved, individual funds, even though unclaimed? I believe not, and although, as claimed by counsel for the trustee, there is, under the terms of section 3186, Revised Statutes (Comp. St. § 5908), no specific statutory lien in this case, I am yet of the opinion that sections 3466, Revised Statutes, and 64a of the Bankruptcy Act do give the government a priority right in the premises, and that such priority right as thus set forth is a declaration of the common-law right of

the sovereign to be first paid. *U. S.* v. *National Surety Co.*, 254 U. S. 73, 41 Sup. Ct. 29, 65 L. Ed. 143.

> At common law the crown of Great Britain, by virtue of a prerogative right, had priority, over all subjects for the payment out of a debtor's property of all debts due it. The priority was effective alike whether the property remained in the hands of the debtor, or had been placed in the possession of a third person, or was in custodia legis. The priority could be defeated or postponed only through the passing of title to the debtor's property, absolutely or by way of lien, before the sovereign sought to enforce his right. * * * The right of priority has been likened to an equitable lien. *State* v. *Rowse*, 49 Mo. 586; *Marshall* v. *New York*, 254 U. S. 382–386, 41 Sup. Ct. 144, 145 (65 L. Ed. 315).

At all times, during the years in question, as already said, there were funds in the business to which each partner, under the articles of copartnership, might have laid claim as his own. They were his to do with as he pleased, and they were the very funds which, in part, served as the foundation for the imposition of the tax, collection of which is herein sought. The fact that each partner was willing to forego the physical withdrawal of these funds can not, in my opinion, succeed in defeating the government's equitable lien.

It should be borne in mind that this proceeding is not designed to tax the partnership for taxes due from the individuals, and therefore runs in no wise counter to the Revenue Acts of 1917. (Com. St. § 6336–3/8a et seq.) and of 1918 (Com. St. Ann. Supp. 1919, § 6336–1/8a et seq.) The

taxes herein have been assessed against the individuals, and all that is now sought is an available and proper fund out of which to collect the same, as so assessed.

(3) The government's claim for taxes is not to be classed with a creditor's claim for the payment of an ordinary debt, for "taxes are not debts, but imposts levied for the support of the government." *U. S.* v. *Proctor* (D. C.), 286 Fed. 272; *New Jersey* v. *Anderson*, 203 U. S. 483, 27 Sup. Ct. 137, 51 L. Ed. 284. See, also *Lane County* v. *Oregon*, 7 Wall 71, 19 L. Ed. 101; *Meriwether* v. *Garrett*, 102 U. S. 472, 26 L. Ed. 197; *Crabtree* v. *Madden*, 54 Fed. 431, 4 C. C. A. 408; *City of Camden* v. *Allen*, 26 N. J. Law, 398.

Therefore, in my opinion, the government's claim, being in the nature of an equitable lien, has followed the property into the hands of the trustee in bankruptcy, where it awaits satisfaction. And this satisfaction, so far as Hugo Schaefer is concerned, should first be had by applying to the government's claim the $1,000 found by the referee to be his individual property.

Concerning the referee's finding that no assets of any kind belonging to the said individual partners came into possession of the trustee in bankruptcy, and that neither of the individual partners had any taxable income for the years involved which could form the basis of a tax claim against them, it is worthy of note that the bankrupts themselves do not agree with that conclusion, as evidenced by the sworn schedules of assets and liabilities filed by them in the bankruptcy proceeding.

An examination of these schedules shows that they charge themselves as owing the United States

$3,887.19 and $3,921.21, respectively, for income taxes; the same being approximately the totals of the amounts claimed to be due from them on original returns filed for the years 1918 and 1919. These statements are, of course, not binding on the trustee, but, in view of the fact that they are so clearly declarations against interest, taxes not being dischargeable claims, they would seem to be strongly confirmatory of the Government's contention that the funds to which, under the articles of copartnership, the individual partners were entitled to lay claim and yet left in the partnership, were, in truth, individual moneys, so far as a govermental tax collection matter is concerned. To argue otherwise were to establish the right of the individual connected with a partnership, to determine largely what should or should not be subjected to taxation.

The 1921 Revenue Act (Comp. St. Ann. Supp. 1923, § 6336⅛a et seq.), as did the 1918 act, provides that individuals carrying on a partnership business shall be liable for income tax in their individual capacity only, and that there shall be included in computing the next income of each partner his distributive share, whether distributed or not, of the next income of the partnership for the taxable year, or if his income is computed upon the basis of a period different from the basis upon which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any annual accounting period of the partnership ending within the fiscal year or calendar year, upon the basis of which the partner's net income is computed.

In the instant case there were admittedly net profits accuring to each partner during the years 1917, 1918, and 1919, and while it may be true that in 1920 there occurred a loss of more than $40,000, which in effect wiped out the prior profits, I am yet of the opinion that, inasmuch as the undisturbed net profits of each individual partner for 1917, 1918, and 1919 were more than sufficient to pay the government's tax and were in nowise so earmarked as to indentify them with the funds paid out in connection with the loss in 1920, the funds remaining in the trustee's hand are liable in their entirety for the government's lien until the same is paid; in other words, that each individual partner, during those years, had in reality a taxable income forming the basis for a tax claim against him.

(4) The loss in 1920 can not in any event be charged against the profit of the three previous years, for the reason that the Revenue Act of 1918, § 204, in force when this loss occurred, provides that the only net loss which a taxpayer might deduct was a loss in the operation of his business occurring after October 31, 1918, and before January 1, 1920. This loss, having occurred subsequent to this last-named period, is only deductive on a return of income for 1920.

Inasmuch as the undistributed profits in a partnership are to be sued, as far as they extend as the basis for the computation of an individual income tax, a partner possessed of such profits certainly has a taxable income, and such income, even in the guise of partnership funds, is available for collection, as well as computation, purposes.

I am, therefore, of the opinion that the Government is right in its contention (1) that the so-called

partnership assets of Brezin and Schaefer, made up as they were, are liable for the payment of taxes owed by the individual partners, and (2) that both of the individual partners had taxable incomes for the years 1917, 1918, and 1919, properly forming the basis of a tax claim against them.

The order of the referee, therefore, so far as it disallows the Government's demand and instructs the trustee that the same does not constitute a claim against the estate in his hands, is reversed.

An order in conformity with the views herein expressed may be presented and will be signed.

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